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Cafeteria Plans and Health Care Benefits

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CAFETERIA PLANS AND HEALTH CARE BENEFITS

I. Introduction

In response to a rapidly changing work force, many employers have developed cafeteria plans for their employees under section 125 of the Internal Revenue Code.[1] In essence, a cafeteria plan permits an employee to tailor employment benefits to his or her particular needs by allowing the selection of a combination of cash and certain nontaxable benefits. For example, a young and healthy single parent may opt for a low priced medical plan and child care benefits in lieu of the more costly traditional medical plan, while a member of a dual income family may prefer life insurance and retirement savings plans when the other working spouse receives adequate medical and dental coverage for the family.

Employers have acclaimed the financial involvement of the employees in the selection of benefits as a valuable contribution toward the containment of health care costs.[2] Additionally, this flexible approach to benefit plan design provides employers with an opportunity to emphasize to employees the economic value of the various benefits offered.

Cafeteria plans have, however, recently come under attack by the Treasury Department.[3] The increased scrutiny is primarily attributable to federal revenue losses in a time of tremendous budget deficits and rapidly rising health care expenditures.[4] In 1984, reaction to these problems took the form of proposed regulations and legislation concerned with the structure of section 125.[5]

In 1985, further legislation on cafeteria plans is likely following the completion of a study by the Secretary of Health and Human Services on cafeteria plans.[6] The Secretary's study is expected to explore the effects

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1. I.R.C. § 125(a) (1984).
2. Geisel, *IRS Proposals Would Kill FSA's As Cost-control Tool*, Bus. Ins., May 14, 1984, at 1, col. 1.
3. *See* I.R.S. News Release 84-22, Pens. Plan Guide (CCH) ¶ 179, 190 (1984).
4. National health care expenditures increased 15.3% in 1980, 12.5% in 1982, and 10.3% in 1983. Geisel, *Increase in Health Care Costs Slowing Down*, Bus. Ins., Oct. 22, 1984, at 30, col. 1.
5. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 531, 98 Stat. 883 (1984) (codified at I.R.C. § 125 (West Supp. 1985)).
6. The Secretary of Health and Human Services, along with cooperation from the Secretary of

of cafeteria plans on the containment of health care costs. In addition, the study will recommend modifications to cafeteria plan rules that "optimize the potential to reduce medical costs while balancing against other health care policy goals."[7]

As an introduction to cafeteria plans, this Comment reviews section 125 of the Internal Revenue Code. The Comment then examines the medical benefits code sections as they function within a cafeteria plan. Additionally, the need to prohibit the use of individual salary reduction agreements within cafeteria plans is analyzed in light of traditional salary reduction agreement requirements, health care cost containment goals and equity concerns. Particular attention is given to the health care benefits within cafeteria plans and the potential for containment of health care costs given the current structure of Code provisions relating to health care benefits. The Comment concludes by suggesting changes to section 105 in ways that mandate the containment of health care costs while continuing the encouragement of private sector provision of health care coverage.

II. An Overview of Section 125

A. *Background*

Cafeteria plans formed under section 125 of the Internal Revenue Code are designed to provide protection against the recognition of income through the doctrine of constructive receipt. Under the doctrine of constructive receipt, taxable income is recognized for amounts "not actually reduced to a taxpayer's possession . . . [but] which is . . . made available so that he may draw upon it at any time . . . ."[8] Section 125 does not create any new employee benefits, but incorporates other code sections[9] into a cafeteria plan.

The Miscellaneous Revenue Act of 1980[10] amended section 125(d)

the Treasury, shall conduct a study of the effects of cafeteria plans on the containment of health care costs and prepare a report no later than April 1, 1985. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 531(b)(6), 98 Stat. 883 (1984).

7. Conference Agreement on H.R. 4170, 98th Cong., 2d Sess., 130 CONG. REC. H6692 (daily ed. June 22, 1984).

8. Treas. Reg. § 1.451-2(a) (1979).

9. I.R.C. § 79 (1984) (group term life insurance); *id.* § 104 (compensation for injuries or sickness); *id.* § 105 (amounts received under accident and health plans); I.R.C. § 106 (1984) (contributions by employer to accident and health plans); *id.* § 120 (qualified group legal services plans); *id.* § 129 (dependent care assistance programs).

10. Pub. L. No. 96-605, § 226(a), 94 Stat. 3529 (1980).

to allow inclusion of a qualified cash or deferred arrangement.[11] The addition of this popular benefit[12] and the absence of Treasury Regulations led to the development of cafeteria plans which were increasingly bold in their interpretation of constructive receipt protection. Specifically, employers proceeded to develop cafeteria plans that included "flexible spending accounts" (FSA's).[13] Whether funded by bonus money from the employer or through a salary reduction by the employee, these accounts or arrangements could be used to "reimburse" the employee for such items as medical expenses not covered under the group insurance plan.[14] FSA's were also used for legal expenses, child care, group insurance premiums, and other nontaxable employee benefits.[15] Some plans went so far as to include parking costs and use of health facilities.[16] Any amounts not used for reimbursement of expenses were to be paid to the employee in cash as taxable income, typically at the end of the year.

Faced with the potential for widespread abuse through FSA's, the Internal Revenue Service (I.R.S.) stated on February 10, 1984 that " 'flexible spending' and similar arrangements . . . are without substance and do not reduce employees' taxable income."[17] The I.R.S. further characterized any "reimbursement" arrangement under which the reimbursement was no more than what the employee would have received had no expenses been incurred as an invalid cafeteria plan.[18] Taxes, interest, and penalties for failure to withhold or report income were to be applied retroactively to employers and employees for prior reported tax years.[19]

The proposed section 125 regulations issued on May 7, 1984 modified this hardline position towards retroactivity by providing transition rules for invalid plans in existence before May 7, 1984, which were modified prior to September 4, 1984.[20] The requirements concerning the election of benefits prior to the beginning of the plan year and the forfeiture

11. I.R.C. § 401(k) (1984).

12. *Survey Shows That Popularity of Section 401(k) Plans Among Large Firms Also Spreading to Medium-Sized and Smaller Firms*, EBPR RESEARCH REP. (Spencer) 206.1.-47 (Oct. 1984).

13. Drury, *Firms Embrace Flexible Spending Accounts*, Bus. Ins., Jan. 9, 1984, at 1, col. 1.

14. *Id.*

15. *Id.*

16. *See Employee Benefits*, 10 TAX MGMT. (BNA) No. 6, at 131 (June 1984) (discussion of nontaxable benefits thought to be includable prior to the Tax Reform Act of 1984).

17. *See* I.R.S. News Release 84-22, PENS. PLAN GUIDE (CCH) ¶ 170, 190 (1984).

18. *Id.*

19. *Id.*

20. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,322 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

of any benefits remaining unused at the end of the plan year received further elaboration in the proposed regulations.[21]

B. *Section 125 as Amended by the Tax Reform Act of 1984*

The Tax Reform Act of 1984 refined the definition of a cafeteria plan[22] as a written plan under which all participants are employees who may choose from two or more benefits.[23] Additionally, the benefits employees may choose from are now limited to cash and statutory nontaxable benefits,[24] as opposed to the prior language which provided that benefits available within a cafeteria plan "may be nontaxable benefits, or cash, property, or other taxable benefits."[25]

With the exception of certain specifically enumerated code sections,[26] nontaxable benefits are those benefits which are expressly excluded from an employee's gross income by other Internal Revenue Code provisions. Also included within the category of statutory nontaxable benefits is group term life insurance in excess of $50,000. Such excess is includable in income only because of the Code's limit[27] on the amount of life insurance that may be provided without affecting the employee's gross income.[28] Furthermore, group term life insurance provided for an employee's spouse or children may also be included in a cafeteria plan,[29] although the value of this benefit is taxable to the employee.[30]

Vacation days are not explicitly included in the statutory language of section 125, but are discussed in the Conference Agreement.[31] The Agreement states that vacation days may be offered as a nontaxable bene-

21. Interestingly, the proposed regulations allow salary reduction agreements, established prior to commencement of the plan year, as an acceptable means of funding appropriately restricted flexible spending arrangements or accounts. *Id.* For a further discussion of salary reduction agreements *see infra* notes 104-28 and accompanying text.

22. The Tax Reform Act of 1984, § 531(b)(1), I.R.C. § 125(d) (West Supp. 1985).

23. *Id.*

24. *Id.*

25. I.R.C. § 125(d) (1984).

26. The Tax Reform Act of 1984, § 531(b)(2)(A), I.R.C. § 125(f) (West Supp. 1985). The exceptions include: I.R.S. § 117 (1984) (scholarship); *id.* § 124 (Vanpooling); *id.* § 127 (educational assistance); *id.* § 132 (statutory fringe benefits).

27. I.R.C. § 79 (1984).

28. This provision effectively returns "other taxable benefits" to the realm of cafeteria plans. The Tax Reform Act of 1984, § 531(b)(2)(A), I.R.C. § 125(f) (West Supp. 1985).

29. H.R. 4170, 98th Cong., 2nd Sess., 130 CONG. REC. H6691 (daily ed. June 22, 1984). The inclusion of group term life insurance for dependents is analogous to the inclusion of group term life in excess of $50,000 for employees. Both coverages are often inseparable parts of the employer's group term life plan, yet the value of each is included in the employee's gross income. *Id.*

30. *See* I.R.C. § 79(a) (1984) (exclusion from gross income of the value of group term life extends only to coverage for the employee).

31. H.R. 4170, 98th Cong., 2nd Sess., 130 CONG. REC. H6691 (daily ed. June 22, 1984).

fit under a cafeteria plan only if the plan precludes any unused vacation days from being cashed-out at year end or carried forward to a future period.[32] This is treatment consistent with that given deferred compensation plans within section 125.[33]

Deferred compensation is generally excluded from cafeteria plans.[34] However, a cafeteria plan may include the portion of a profit-sharing or stock bonus plan having a qualified cash or deferred arrangement as defined by Internal Revenue Code § 401(k)(2).[35] Under this arrangement, employees may elect to have a portion of their salary contributed by the employer to a trust for payment at retirement.[36] Consequently, the employees pay no federal income tax on either the amount contributed or any interest earned thereon until these amounts are distributed.[37]

The ability to include qualified cash or deferred arrangements in cafeteria plans was necessary to allow the establishment of a single plan providing for employee choice.[38] It was generally felt that prior law was too restrictive in that it did not allow a choice between "current compensation and other benefits" to be provided to employees under a single plan.[39]

Under the Tax Reform Act of 1984,[40] nondiscrimination rules regarding highly compensated individuals,[41] originally enacted in 1978,[42] were expanded to include nondiscrimination rules concerning key em-

32. *Id.* The proposed regulations discussed in the next section also provide for the inclusion of vacation days in a cafeteria plan. Since these proposed regulations conflict with the Tax Reform Act of 1984 primarily for transition purposes and are not specifically superseded with respect to vacation days, it may be inferred that vacation days are includable in cafeteria plans as a nontaxable benefit even though the choice of cash instead of vacation days rise to a taxable benefit, i.e. additional cash to the employee. Also, vacation day compensation is taxable. *Id.* However, the choice of a nontaxable benefit such as medical plan coverage in lieu of vacation days would support a nontaxable benefit characterization of vacation days since the choice of either benefit would not give rise to a change in the employee's taxable income.

33. I.R.C. § 125(d)(2) (1984). "Deferred compensation" includes qualified plans as generally defined in I.R.C. § 401 and nonqualified plans as provided for in Rev. Rul. 60-31, 1960-1 C.B. 174.

34. I.R.C. § 125 (1984).

35. *Id.* § 125(d)(2).

36. *Id.* § 401(k)(2)(B). The proposed distribution restrictions limit this program to a retirement savings vehicle more so than other qualified defined contribution plans. *See* Proposed Treas. Reg. § 401(k)-l(d) (1984).

37. However, FUTA and FICA taxes are applied at the time of contribution. *See* I.R.C. §§ 3306(r)(1)(A), 3121(v)(1)(A) (1984).

38. S. REP. No. 1036, 96th Cong., 2d Sess. 7322 (1980).

39. *Id.*

40. The Tax Reform Act of 1984, § 531(b)(3), I.R.C. § 125(b) (West Supp. 1985).

41. No statutory or regulatory definition of "highly compensated participant" has been formulated at this time. *See, e.g.*, I.R.C. § 125(e)(1)(C) (1984) (uses the term "highly compensated" to define a "highly compensated participant")

42. *See* I.R.C. § 125(b), (c), (g) (1979).

ployees.[43] Generally, a cafeteria plan may not discriminate in favor of highly compensated individual on the basis of either eligibility, or benefits and contributions.[44] Also, special rules are provided for collectively bargained cafeteria plans[45] and plans which include health benefits.[46] A cafeteria plan will be considered discriminatory in favor of key employees if the statutory nontaxable benefits provided to key employees exceeds 25% of the total statutory nontaxable benefits provided to all employees.[47] Accordingly, if the plan fails to satisfy the respective nondiscrimination rules, then the plan benefits will be treated as taxable income to the highly compensated or key employees to the extent that taxable benefits are available.[48]

In addition to the previously discussed section 125 nondiscrimination rules, nondiscrimination rules from the various Code sections also apply. Except for the more restrictive health benefits test,[49] the cafeteria plan rules are generally duplicative of the incorporated section provisions. This duplication is illustrated in the following examples. First, the benefits of a group term life plan that discriminates in favor of key employees will be treated as taxable income to those key employees.[50] Second, reimbursements under a discriminatory self-insured medical

43. The Tax Reform Act of 1984, § 531(b)(3), I.R.C. § 125(b) (West Supp. 1985).

44. I.R.C. § 125(b), (c) (1984). This section provides that I.R.C. § 125(a) will not apply if the plan discriminates in favor of the "highly compensated individuals" as to eligibility, or benefits and contributions. *Id.* It further provides that if no discrimination is found for nontaxable benefits and total benefits, or for nontaxable benefit contributions and total benefit contributions by the employer, then section 125(a) protection will apply for the highly compensated employees as well as others. In other words, the plan must pass the eligibility test *and* either the contribution test or the benefit test. *Id.*

45. I.R.C. § 125(g)(1) (1984).

46. I.R.C. § 125(g)(2) provides a method of satisfying the nondiscrimination test required by section 125(b)(1)(B) where a cafeteria plan includes health benefits. Such a plan is not discriminatory if either of two tests are met. *Id.* § 125(g)(2)(A). The first requires that contributions for all participants be equal to 100% of the cost of the health benefit coverage selected by a majority of the highly compensated. *Id.* Alternatively, contributions for all participants must equal or exceed 75% of the cost of coverage of the participant having the highest cost health benefit coverage. *Id.* Under either test, a further requirement that contributions or benefits in excess of those needed to meet the foregoing tests bear a uniform relationship to compensation is imposed. *Id.* § 125(g)(2)(B).

Both tests also include language referring to "similarly situated" participants. This may refer to the common practice of providing varying benefit levels to employees in different locations or divisions. No legislative history or proposed regulation is available on this point.

47. The Tax Reform Act of 1984, § 531(b)(2), I.R.C. § 125(f) (West Supp. 1985).

48. *Id.* § 531(b)(1), I.R.C. § 125(d). However, the section 125(a) protection will apply to all employees other than the highly compensated or key employees within a discriminatory plan. *Id.*

49. I.R.C. § 125(g)(2) (West Supp. 1985).

50. I.R.C. § 79(d) (1984). The same definition of key employee is used for cafeteria plans and group term life plans. *See id.* § 416(i)(1).

reimbursement plan will be taxable to highly compensated individuals.[51] Third, a group legal services plan will not qualify as a nontaxable employee benefit if it discriminates in favor of officers, shareholders, self-employed individuals, or highly compensated employees on the basis of benefits, contributions or eligibility.[52] Fourth, a similar qualification problem will arise under a dependent care assistance program if it discriminates in favor of shareholders, highly compensated employees, and owners.[53] Finally, a cash or deferred arrangement[54] will fail to qualify for favorable tax treatment for employees if the plan, based on actual salary deferrals selected by employees, discriminates in favor of the highest paid one-third of the total eligible group.[55]

A full discussion and analysis of the nondiscrimination rules applicable to a cafeteria plan is beyond the scope of this Comment. However, the various rules that have been mentioned provide a general idea of the complexity involved in the design of a cafeteria plan. The existence and perceived need for these rules has come under sharp attack in public hearings on employee benefits and cafeteria plans before the Senate Finance Subcommittee on Taxation and Debt Management[56] and the Internal Revenue Service.[57]

C. *Highlights of Proposed Section 125 Regulations*

As several issues addressed in the proposed section 125 regulations were published prior to passage of the Tax Reform Act of 1984 and, thus were superceded or clarified by the Act, corresponding changes will also be required in the proposed regulations. These changes will have to deal with such issues as the definition of a cafeteria plan,[58] the includable benefits,[59] and the transition rules for compliance of plans existing prior to

51. *Id.* § 105(h). The description of highly compensated individuals found in section 105(h)(5) varies significantly from the description provided in section 125(e) for cafeteria plans.

52. *Id.* § 120(c)(1).

53. *Id.* § 129(d)(2).

54. *See supra* notes 10-12 and accompanying text.

55. I.R.C. § 401(k)(4) (1984). As a practical matter, a plan sponsor may simply limit the amount that the highest paid one-third of employees may defer in order to meet the well-defined nondiscrimination tests.

56. *Taxation of Fringe Benefits*, 98th Cong., 2d Sess., 130 CONG. REC. D972 (daily ed. July 26, 1984).

57. *Internal Revenue Service: Hearings on Proposed Cafeteria Plan Regulations*, PENS. PLAN GUIDE (CCH) ¶ 25,592, at 27,015-86 (1984).

58. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,322 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

59. *Id.* at 19,323.

the issuance of the proposed regulations.[60] Moreover, other modifications of a less substantial nature will be required throughout the proposed regulations in order to be consistent with the recent legislation. For example, references to "taxable benefits" will have to be changed to "cash" due to the new definition.[61]

Several housekeeping items were addressed in the proposed regulations. In particular, the proposed regulations set forth 1) the required contents of a cafeteria plan document,[62] 2) the expansion of the term "employees" to include dependents and former employees,[63] 3) the prohibition of benefit carryovers to a subsequent period,[64] and, 4) the determination and timing of taxes imposed on the highly compensated in the case of a discriminatory plan.[65] Furthermore, guidance was provided as to the use of salary reduction agreements,[66] and rules were formulated for the timing and subsequent changes that may be made regarding an employee's selection of benefits.[67]

The proposed regulations further elaborated upon the I.R.S. News Release requirement that benefit selections must be made prior to the benefit period.[68] The focus is whether a benefit is "currently available" to a participant. According to the proposed regulations, if a participant is to avoid constructive receipt of a taxable benefit, then the benefit must not be "currently available" to the participant during the period.[69] A benefit is considered "currently available" if a participant could elect to receive that benefit at will or upon giving notice of an election,[70] and is not "currently available" if the receipt of the benefit is subject to delay and conditions which impose a substantial risk of nonreceipt.[71]

The proposed regulations also clarify the nondiscrimination rules with respect to benefits for the highly compensated.[72] The proposed test

60. *Id.* at 19,328.
61. *Id.*
62. *Id.* at 19,322.
63. *Id.* at 19,323.
64. *Id.* at 19,324. A carryover of benefits to a subsequent period would amount to a deferral of compensation which is a prohibited form of benefit for a cafeteria plan, with the exception of a section 401(k) arrangement. I.R.C. § 125(d)(2) (1984).
65. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,324-25 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).
66. *Id.* at 19,323.
67. *Id.* at 19,324.
68. *Id.* at 19,325.
69. *Id.*
70. *Id.*
71. *Id.* The language used in the proposed regulations is similar to the requirements for avoiding constructive receipt in deferred compensation arrangements. Rev. Rul. 60-31, 1960-1 C.B. 174.
72. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,328 (1984) (to be codified at 26 C.F.R. pt.

for discrimination will not only include the benefits *available*, but also the benefits *actually selected* by the highly compensated employee.[73] A selection test as well as an availability test is a needed refinement since a salary reduction agreements with no percentage-of-income limit would effectively render nontaxable benefits fully available to all employees. For instance, while a nontaxable benefit package worth $5,000 would theoretically be available to both the $10,000 and the $100,000 wage earners alike, few $10,000 wage earners could afford to forego a full $5,000 from their salary. The proposed regulations further provide that "a cafeteria plan must not discriminate in favor of the highly compensated participants in operation."[74] The proposed regulations provide an example in which the duration of the plan is determined by the needs of the highly compensated, which would be possible in a small and closely-held corporation.[75]

Any determination of discrimination in favor of the highly compensated "will be made on the basis of the facts and circumstances of each case."[76] Neither safe harbor formulas nor examples of plans in compliance are provided concerning discrimination on the basis of benefits. However, some guidance is given as to employer contributions on behalf of employees.[77] The proposed regulations indicate that a cafeteria plan may limit the participant's purchases of benefits to specified amounts or percentages of compensation.[78] Clarification is needed as to the acceptability of the common practice of employers contributing more dollars toward some benefits, such as medical insurance, for an employee with dependent coverage as compared to an employee without dependent coverage.

III. HEALTH AND ACCIDENT BENEFITS CODE SECTIONS

A. *I.R.C. Section 106: Contributions by Employer to Accident and Health Plans*

Section 106 of the Internal Revenue Code provides that the gross income of an employee does not include contributions made by the em-

1) (proposed May 7, 1984). Contributions to a plan, as opposed to benefits, are easily measured. *See infra* notes 78-79 and accompanying text.

73. *See* Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,328 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* at 19,323.

78. *Id.*

ployer to accident or health plans.[79] The employer contributions may be in the form of a premium payment to an insurance company,[80] a contribution to a "trust or fund" which provides plan benefits,[81] or to the employee for reimbursement of accident and health policy premiums.[82] Unlike several of the other Code sections which may be incorporated in a cafeteria plan,[83] section 106 does not include a requirement of a separate written plan or an imposition of nondiscrimination rules.

Within a cafeteria plan, an employee may select from among cash and other nontaxable benefits, such as employer contributions to an accident and health plan.[84] Since it is possible to offer only two benefits under a cafeteria plan,[85] the employee choice could be limited to employer contributions and cash.[86] For example, a salary reduction agreement which reduces an employee's salary to the extent of the required employee contribution creates the necessary choice between cash and a nontaxable benefit.[87] The foregone portion of the salary is recharacterized as an employer contribution.[88]

B. *I.R.C. Section 105: Amounts Received Under Accident and Health Plans*

Generally, amounts received by an employee through accident and

79. I.R.C. § 106 (1984).

80. Treas. Reg. § 1.106-1 (1984).

81. *Id.*

82. Rev. Rul. 61-146, 1961-2 C.B. 25. The reimbursement must be made subject to proof of coverage in force and payment by the employee of the premiums. *Id.* A different treatment of employer reimbursements is made where *no* proof of coverage was required. *See* Rev. Rul. 57-33, 1957-1 C.B. 303 (taxable wages); Rev. Rul. 75-241, 1975-25 I.R.B. 16 (compensation includable in gross income).

83. *See* I.R.C. §§ 120, 129 (1984); Treas. Reg. § 1.105-11 (1984).

84. The Tax Reform Act of 1984, § 531(b)(1), I.R.C. § 125(d) (West Supp. 1985).

85. I.R.C. § 125(d)(1)(B) (1984).

86. The Tax Reform Act of 1984, § 531(b)(1), I.R.C. § 125(d) (West Supp. 1985). The proposed regulations further provide that a cafeteria plan "must offer at least one taxable benefit and at least one nontaxable benefit." Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,322 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

87. The choice of cash or a nontaxable benefit is usually analyzed at the point of the benefit selection transaction, as opposed to the salary reduction agreement. However, an individual salary reduction itself is clearly a choice of a nontaxable benefit instead of cash. To analyze it otherwise would require the assumption that some participants would reduce their salary in order to choose a cash benefit from their spending account.

The only time a cash benefit would logically be taken after a salary reduction is in the case of an unused balance in a spending account. However, the cash-out of unused balances is not allowed under the proposed regulations. If cash-outs were possible, it could still be argued that the amount of salary not reduced is a choice of cash in lieu of nontaxable benefits.

88. "A salary reduction agreement will have the effect of causing the amounts contributed thereunder to be treated as employer contributions . . . ." Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,323 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

health insurance attributable to employer contributions are includable in the employee's gross income.[89] However, an exception to this rule is provided for amounts received by an employee for medical care expenses not attributable to itemized deductions taken under section 213 of the Internal Revenue Code.[90]

Reimbursements of an employee's medical expenses may be made from a self-insured plan or fund, and will be treated as though provided through insurance as long as additional requirements are met.[91] Specifically, the self-insured plan must be a separate written plan[92] and it must not discriminate in favor of the highly compensated employees.[93] This latter rule is limited to self-insured plans "[b]ecause underwriting considerations generally preclude or effectively limit abuses in insured plans . . . ."[94]

Benefit payments from many kinds of insured and self-insured medical plans are considered medical expense reimbursement plans for purposes of section 105 and excluded from an employee's gross income. Generally, two types of medical plans can be identified, regardless of whether the plans are insured or self-insured. The first type of plan is the "catastrophic coverage" plan typically provided by employers regardless of whether a cafeteria plan is offered.[95] Although the coverage provided for small medical expenses varies from one plan to the next, most plans provide high dollar limits for severe accidents and illnesses, and will usually exclude routine and cosmetic medical expenses.[96]

The second type of plan is often referred to as a "medical reimbursement" plan. This plan typically provides for reimbursement of expenses that are not covered under the catastrophic coverage plan because of the application of deductibles, co-insurance or specific plan exclusions, such as cosmetic treatment. For purposes of clarity, this second type of plan will be referred to herein as a "routine expense reimbursement" plan.

89. I.R.C. § 105(a) (1984).

90. I.R.C. § 105(b) (1984); *see also id.* § 213 (provides for the deductibility of medical expenses in excess of five percent of adjusted gross income).

91. *See id.* § 105(e) (reference to "plan" and "fund"); *id.* § 105(h) (reference to self-insured).

92. Treas. Reg. § 1.105-11(b) (1984).

93. I.R.C. § 105(h) (1984).

94. *Senate Committee Report on P.L. 95-600, § 366,* 4 STAND. FED. TAX REP. (CCH) ¶ 11,270 (1985). As a practical matter, however, this is not true since "insured plans" have been developed that allow for discrimination. THE BUSINESS INSURANCE HANDBOOK 614 (1981).

95. *See* Z. LIPTON, SUPPLEMENTAL MAJOR MEDICAL AND COMPREHENSIVE PLANS, THE HANDBOOK OF EMPLOYEE BENEFITS: DESIGN, FUNDING AND ADMINISTRATION 163-81 (J. Rosenbloom ed. 1984) (describes the most common major medical plans for catastrophic coverage).

96. *Id.* at 177.

In order to facilitate employee choice and depending upon the method of assigning values to the plans, the treatment of these two types of plans within a cafeteria plan may be handled in a variety of ways. For instance, selection of a catastrophic coverage plan will usually entail the allocation of spending account dollars, or credits, to the cost of the plan. This allocation results in the employee contribution being characterized as an "employer contribution," which is a nontaxable benefit under section 106. Consequently, the subsequent payments of benefits from this plan are excluded from the employee's gross income under section 105(b).[97]

When a "routine expense reimbursement" plan is offered within a cafeteria plan, two approaches are possible. The first approach, which is similar to the allocation described above for a catastrophic coverage plan, involves the allocation of spending account dollars to a premium or a self-insured fund. Both sections 106 and 105(b) operate to respectively exclude employer contributions and reimbursement payments for medical care from the employee's gross income.[98]

The second approach to a cafeteria plan design is the use of an employee's spending account dollars to directly fund "routine expense reimbursements." This approach, when used in conjunction with a salary reduction taken at or after the time of the expense, has incurred the wrath of the I.R.S. and the Treasury Department.[99] If any medical expenses are not reimbursed by the catastrophic coverage plan, the employee may be reimbursed with dollars from his own spending account to the extent those dollars are available.

Prior to February 10, 1984, cafeteria plans which included a "routine expense reimbursement" plan generally provided for the distribution of unused spending account dollars at the end of the year.[100] Reimbursement of cash in lieu of reimbursement for medical expenses, however, creates taxable income under section 105.[101] The rationale underlying

97. I.R.C. § 105(b) (1984).

98. *Id.* §§ 106, 105(b).

99. *See* I.R.S. News Release 84-22, PENS. PLAN GUIDE (CCH) ¶ 170, 190 (1984). Letter from John C. Chapton, Assistant Treasury Secretary to Robert J. Rubin, M.D., Assistant Secretary, Department of Health and Human Services. 23 TAX NOTES 308 (1984). Of particular concern was the zero balance account (ZEBRA) which allowed the employee to reduce his salary *after* an expense was incurred. This achieved payment of *all* medical expenses with pre-tax dollars. *Id.*

100. *See supra* note 17 and accompanying text.

101. "[S]ection 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care." Treas. Reg. § 1.105-2 (1960). The United States Court of Appeals for the Ninth Circuit has held that the availability of cash at some time in the future will not disqualify a distribution due to disability from a profit-

this development of the cash-out provision was the constructive receipt protection of section 125(a).[102] However, in support of the I.R.S. position against the cash-out of unused spending account dollars, section 105 regulations further stipulate that the rules of section 105 "will determine the status of a benefit as a taxable or nontaxable benefit" for purposes of inclusion in a cafeteria plan.[103]

IV. Salary Reduction and Welfare Plans

A. *Description of Salary Reduction*

Salary reduction agreements for pre-tax retirement savings are available for employees participating in a cafeteria plan which includes a qualified cash or deferred arrangement.[104] Salary reduction agreements have also been allowed in nonqualified deferred compensation agreements, if the income is deferred to a future period and the agreement contains an element of risk.[105] With the advent of section 125 and its protection to the employee from taxation under the constructive receipt doctrine,[106] salary reduction agreements are now being used in conjunction with welfare plans.[107] The use of salary reduction agreements for purposes of funding a welfare plan provides an opportunity to reduce taxable income, while the deferred compensation context implies only a postponement of tax.

B. *Potential for Discrimination: Individual vs. Across-the-Board Salary Reduction*

As in the case of statutory qualified deferred compensation plans,

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sharing plan for the section 105 exclusion as an accident and health plan payment. Wood v. United States, 590 F.2d 321 (9th Cir. 1979). This case, however, dealt with the section 105(c) exclusion relating to payments from an accident and health plan due to permanent loss of a functional part of the body. *Id.* The rules surrounding the exclusion of these payments from the recipient's gross income differ markedly from the medical care expense reimbursement rules. *Compare* I.R.C. § 105(c) (1984) *with* I.R.C. § 105(b) (1984).

The United States Court of Appeals for the Second Circuit has, however, criticized *Wood* for finding that a profit sharing plan had a dual purpose based on the nature of the plan distribution. *See* Caplin v. United States, 718 F.2d 544 (2d Cir. 1983). The Court emphasized that the plan document should determine the function of the plan and thus the taxable status of subsequent payments from the plan. *Id.* at 547.

102. *See supra* notes 8-21 and accompanying text.

103. Treas. Reg. § 1.105-11(k)(1) (1960).

104. I.R.C. § 125(d)(2) (1984).

105. Rev. Rul. 60-31, 1960-1 C.B. 174.

106. *See supra* notes 8-21 and accompanying text.

107. Welfare benefit plans are defined as any employee benefit plan except retirement plans. *See* I.R.C. § 419(e) (1984).

qualified welfare plans also have nondiscrimination as a goal.[108] In considering the availability of non-cash benefits, the entire income of a low paid employee is theoretically available for non-cash benefits. In actual practice, however, the low paid employee can only use a large portion of his or her salary for non-cash benefits if that salary is a secondary source of income to the family. Thus, the availability of unlimited individual salary reduction agreements within a cafeteria plan for the purposes of funding welfare plan benefits provides the highly compensated employees a greater opportunity to select non-cash benefits and shelter income from taxation.

Arguably, an employee should be allowed to participate in an individual salary reduction agreement since any employer contributions to fund a cafeteria plan will probably amount to a bonus which the employee would have otherwise received in cash. Likewise, an employer contribution may also amount to a reduction in future increases that employees may receive in cash. Here, a distinction must be drawn between the individual salary reduction and the across-the-board contribution. The salary reduction selection by the employee is unlike across-the-board contributions because the employee may select an individual level of salary reduction. This ability to individually reduce salary may be a discriminatory or inequitable use of non-taxable benefits by key employees. The across-the-board contribution, on the other hand, would be applicable to all eligible employees and, therefore, non-discriminatory.[109]

An employer contribution to all employees in the form of a flat dollar amount would discriminate in favor of the low paid employees since this amount would be a higher percentage of their pay than that of the highly compensated employees.[110] Although an employer contribution based on a percentage of the participating employee's salary would probably be considered non-discriminatory, it should be limited to a maximum level of compensation. By placing a limit on the amount of compensation available for non-taxable benefits, the plan would function in a fashion similar to qualified deferred compensation plans which are

108. *See id.* § 79(d) (nondiscrimination requirements in a group term life plan); *see also* The Tax Reform Act of 1984, Pub. L. No. 98-369, § 531, 98 Stat. 881 (1984) (codified at I.R.C. § 125 (West Supp. 1985)) (establishes nondiscrimination rules effective after December 31, 1984 for Voluntary Employee Beneficiary Associations (VEBA's) and Group Legal Services Organizations (GLSO's)); I.R.C. § 501(c)(9), (20) (1984) (codifies the tax exempt status of VEBA's and GLSO's).

109. *See* I.R.C. § 125(b) (1984); Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,328 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

110. Discrimination in favor of low-paid employees is not prohibited by statute or regulation. *Cf.* I.R.C. § 79 (1984).

subject to section 415 limitations on annual benefit accruals and contributions,[111] and group term life insurance plans subject to limitations on the life insurance amounts available on a non-taxable basis under section 79.[112] This approach would also be similar to the proposed caps on employer deductions for health care plan contributions.[113]

C. *Traditional Salary Reduction Rules and Welfare Plans*

In addition to the inherent discrimination problem posed by unlimited individual salary reduction agreements, the use of salary reduction agreements for welfare plan benefits fails to meet the retirement savings goal found in section 401(k).[114] Specifically, salary reduction agreements for welfare plan benefits do not create any retirement savings and do not provide for the eventual taxation of that deferred income. For that reason, the acceptability of salary reduction agreements for all cafeteria plan benefits is theoretically invalid. The inclusion of section 401(k) plans within cafeteria plans should not imply the appropriateness of section 401(k) discrimination rules for welfare plan benefits. Likewise, the inclusion of section 401(k) in cafeteria plans should not imply the appropriateness of salary reduction agreements for welfare plan benefits.

The use of salary reduction agreements for welfare plan benefits involves substantially less risk when compared to nonqualified deferred compensation arrangements.[115] This necessary element of risk[116] is virtually missing in a situation where the employee is reducing salary for the payment of medical premiums, child care expenses, and possibly additional vacation. Because these items may be planned in advance the employee bears little or no risk of loss.

111. The Code provides that only $30,000 may be contributed annually without taxable income to the employee in a defined contribution plan. *See id.* § 415(c). This section similarly limits the funding for more than a $90,000 annual benefit under a qualified defined benefit plan. *Id.* § 415(b). These benefit limits are frozen for plan years beginning prior to January 1, 1986. *Id.* § 415(d).

112. No more than $50,000 of group term life insurance coverage in a nondiscriminatory plan may be provided to an employee without taxable income consequences. *Id.* § 79 (1984).

113. A senate bill sponsored by Senator Dole in 1984 would limit the deductibility of employer contributions to a medical plan to $70 per month per single employee and $175 per month per employee with covered dependents. S. 640, 98th Cong., 2d Sess. (1984).

114. I.R.C. § 401(k) (1984). The retirement savings goal is embodied in the requirements that such an arrangement "satisfy the normal pension plan qualification rules" plus limit distributions to retirement, death, disability, separation from service or hardship. *Senate Committee Report on P.L. 95-600*, 4 STAND. FED. TAX. REP. (CCH) ¶ 2601.0138 (1985).

115. Rev. Rul. 60-31, 1960-1 C.B. 174.

116. *Id.*

D. *Salary Reduction in Cafeteria Plans*

The proposed section 125 regulation attempts to impose a risk element by requiring a prior election of the allocation of salary reduction amounts to a particular type of benefit.[117] Under the proposed regulations, those amounts are subject to forfeiture and reversion to the employer if not used within the period of potential reimbursement.[118] Since nontaxable benefits such as medical plan premiums and child care expenses may usually be planned,[119] the imposition of prior election and forfeiture seems to add little risk to the arrangement. Of course, some risk is imposed upon "routine expense reimbursement" plans since many medical expenses are not predictable. However, it seems likely that the forfeiture requirement could encourage the unnecessary utilization of medical care by the employee in order to obtain the full value of dollars allocated to a benefit.[120] Furthermore, the forfeiture approach could ultimately reduce the tax base and revenues[121] by eliminating taxable cash-outs.

The central issue in analyzing the viability of salary reduction agreements for funding welfare plan benefits is whether the salary reduction agreements will be subject to the constructive receipt doctrine. The income tax regulations provide that "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time . . . ."[122] This would appear to require that amounts used for "routine expense reimbursement" that are funded by a salary reduction agreement would be subject to taxation under the constructive receipt doctrine. On the other hand, section 125(a) could be interpreted to preclude the application of the constructive receipt doctrine in this situation because no taxable income is attributable to an employee faced merely with the availability of a choice of taxable benefits.

Other than being implied as available due to the inclusion of section 401(k),[123] the salary reduction agreement could be analyzed as either a

117. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,325 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

118. *Id.*

119. Changes in family status are provided for in the proposed regulations. *Id.* at 19,324.

120. *See infra* notes 141-53 and accompanying text.

121. On the other hand, the forfeiture requirement may discourage the use of individual salary reduction agreements and maintain taxable income.

122. *See* Treas. Reg. § 1.451-2(a) (1979).

123. *See* I.R.C. § 401(k) (1984).

"benefit" or a "choice." If analyzed as a benefit, the salary reduction agreement could not be included in a cafeteria plan since it is not currently a statutory non-taxable benefit.[124] If analyzed as a choice within the meaning of section 125, the salary reduction agreement would simply be a practical way of effecting the choice among cash and non-taxable benefits.[125] However, the inclusion of salary reduction agreements as a method of effectuating this choice appears to allow the employee to determine, without a dollar or percentage limit, the taxable character of his or her own income. Clearly, this is very different from a plan with predetermined levels of non-taxable benefits or cash from which the employee may choose.

Salary reduction agreements also create a great many difficulties for "routine expense reimbursement" plans, since the salary reduction itself is effectively a choice of "routine expense reimbursement" in lieu of cash.[126] The use of salary reduction agreements to fund welfare plan benefits within a cafeteria plan appears to be in conflict with the Treasury Department's concern about the abusive nature of spending accounts relative to "routine expense reimbursement" plans.[127] Because of this conflict, inherent discrimination problems, and the technical difficulties involved with "routine expense reimbursement" plans, salary reduction agreements should not be a permissible method of funding cafeteria plans. This conclusion is reinforced by the fact that the traditional deferred compensation salary reduction requirements of risk and deferral to future periods[128] are not easily adapted to welfare plan design.

V. COST CONTAINMENT AND TAX POLICY

The growing use of cafeteria plans has raised several important tax policy issues.[129] The most immediate tax policy concern is the prevention of revenue losses. This concern has been magnified by the current tremendous budget deficits,[130] and illustrated by recent tax legislation

124. The only situation where salary reduction is a statutory non-taxable benefit is in relation to cash or deferred arrangements. *See id.*

125. *See id.* § 125.

126. Such an availability of cash would render the expense reimbursement taxable. Treas. Reg. § 1.105-2 (1960).

127. *See supra* note 99 and accompanying text.

128. Rev. Rul. 60-31, 1960-1 C.B. 174.

129. *See* J. PECHMAN, FEDERAL TAX POLICY 5 (4th ed. 1983) (complete discussion of tax policy issues).

130. The U.S. budget deficit in July, 1984 was $16.42 billion or $197.04 billion annualized. Wall St. J., Aug. 24, 1984, at 1, col. 2.

aimed at reducing these deficits.[131]

A policy goal related to the prevention of further revenue losses is the encouragement of economic efficiency. The current employee benefit tax provisions may be criticized as functioning in opposition to this goal. Because of the tax advantage associated with these plans, the participants may be encouraged to choose benefits that cost more than they would be willing to pay in cash.[132] Plans have become so prevalent that a recent hearing before the House Ways and Means Committee[133] identified that the wage portion of total compensation has "declined over the years, from 92% in 1960 to 84% this year."[134]

The continued rise in health care expenditures is of specific concern to the tax policies of economic efficiency and prevention of revenue losses. Corporate health plans, for instance, are considered to be prime examples of ecomonic inefficiency and have been identified as a major factor contributing to rising medical care costs,[135] now approaching 11% of the Gross National Product.[136] While the nation may question what part of the Gross National Product should be devoted to health care, those charged with revenue collection are concerned with the extent that this expenditure may continue to receive favored tax treatment. Although the concerns most commonly voiced by the Treasury Department and the Health and Human Services Departments are raised with respect to flexible spending accounts,[137] all deductions for health care benefits are under increased scrutiny as a source of revenue to help reduce current budget deficits.[138]

Equity is always an important tax policy issue associated with em-

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131. The Tax Reform Act of 1984 was part of the Deficit Reduction Act of 1984 which combined taxation and spending reform in an effort to reduce the U.S. budget deficit. *See* The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 881 (1984) (codified as amended in scattered sections of 26 U.S.C.).

132. *Economic Choices 1984,* 89 (A. Rivlin ed. 1984) (collection of essays advocating a consumption tax).

133. Harry Ballantyne, SSA Chief Actuary, testifying before the House Ways and Means Committee hearing on the tax free status of employee benefits. WEEKLY NEWS DIGEST, Sept. 21, 1984, at 83.

134. *Id.*

135. Letter from John E. Chapoton, Assistant Secretary for Tax Policy, Treasury Department, to the Small Business Council of America, 18 TAX NOTES 1190 (1983).

136. The $355.4 billion spent on health care in 1983 was 10.8% of the Gross National Product. *See Geisel, supra* note 4, at 30, col. 1.

137. Letter from John E. Chapoton, Assistant Secretary for Tax Policy, Treasury Department to Robert J. Rubin, M.D., Assistant Secretary for planning and evaluation, Department of Health and Human Services, 23 TAX NOTES 308 (1981); Letter form Robert J. Rubin, M.D. to John E. Chapoton, 23 TAX NOTES 547 (1984).

138. *See supra* note 136-37 and accompanying text.

ployee benefits. Although there are nondiscrimination rules imposed on all cafeteria plans,[139] the plans are still frequently geared to the needs of the highly compensated employees.[140] Furthermore, the use of nontaxable benefits reduces the tax base and imposes a greater burden upon those taxpayers who do not have extensive tax deductions.

Finally, the tax code treatment of benefits may encourage the private sector to increase their income security by participating in a welfare plan that offers tax favored treatment of life and medical insurance. Not only do these plans assist the employee at times of financial need, they may also actually help to reduce the budget deficit by providing relief to the public welfare system. Encouragement of private sector retirement plans also provides assistance to public sector welfare programs by supplementing the Social Security retirement system.

Containing the rising cost of health care is a goal shared by the government and private business.[141] A great deal of debate has taken place concerning cafeteria plans on the issue of cost containment. Plan sponsors have defended a spending account approach to cafeteria plan design because it effectively contains the cost of health care by involving the employee in a financial decision encouraging wise purchase of health care services.[142] Lending support to the spending account method is a study by the Rand Corporation indicating that when the employee is required to pay 50% of the bill, as opposed to paying nothing at all, utilization of health care services declines by as much as 18%.[143]

Although it is widely accepted that requiring a financial contribution from the employee will help reduce the utilization of health care services, the use of flexible spending accounts is still under a great deal of scrutiny.[144] This concern centers on the use of pre-tax dollars to purchase medical care services.[145] Because pre-tax dollars are less valua-

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139. *See supra* notes 108-13 and accompanying text.

140. This is especially true for small business planning.

141. Duva, *Benefit Costs Will Remain A Major Concern in 1984*, Bus. Ins., Jan. 9, 1984, at 33, col. 1.

142. *See* Geisel, *supra* note 2, at 1, col. 1.

143. Newhouse, *Cost Sharing in Health Insurance*, 305 NEW ENG. J. OF MED. 1501 (Dec. 1981).

144. This scrutiny is exemplified by the HHS study mandated by the Tax Reform Act of 1984 and the many hearings by the Senate Finance Committee and House Ways and Means Committee on employee benefits. *See supra* notes 6, 56, 57 and accompanying text.

145. "[B]ecause flexible spending arrangements would enable employees to use before-tax dollars to pay virtually all of the health care expenses that are presently paid with after-tax dollars, we believe that the net effect . . . would be to create incentives for employees to use health care . . . ." Letter from John C. Chapoton, Assistant Secretary for Tax Policy, Treasury Department, to Robert J. Rubin, M.D., Assistant Secretary of Health and Human Services. Letter from Robert J. Rubin, M.D. to John C. Chapoton, 23 TAX NOTES 508 (1984). Dr. Rubin's response was agreeable to

ble to the employee than after-tax dollars, the employee's financial involvement is lessened when pre-tax dollars are used.

Exhibits I and II below illustrate a cafeteria plan that uses a spending account to fund either a choice between two medical plan options or the selection of cash. Exhibit I illustrates the value of a catastrophic medical care plan when a significant medical expense is incurred. In contrast, Exhibit II depicts the notion that an employee who is in good health and expects no medical expenses will be better off choosing Plan B and the resulting cash benefit. Similarly, an employee who has coverage through a spouse's plan may be further benefited by selecting cash.

The payment of catastrophic medical plan premiums allowed under section 106 through spending accounts encourages the employee to select

EXHIBIT I

CATASTROPHIC MEDICAL PLAN PREMIUMS

Cafeteria Plan: Premiums for 2 medical plan options or cash

Plan A: $200 deductible, 80% to $2,500 then 100% thereafter
Plan B: $500 deductible, 80% to $5,000 then 100% thereafter

Spending Account:	$1,000
Plan A Cost:	$1,000
Plan B Cost:	$ 800
Medical Bills:	$3,500

Employee: 30% marginal tax rate; no other medical bills.

	Plan A	Plan B	Cash
Plan Reimbursement	$2,900	$2,400	$ -0-
Employee's Medical Expense*	600	1,100	3,500
Unused Spending Account	-0-	200	1,000
Gross Benefit (reimbursements plus cash)	2,900	2,600	1,000
Less Taxes	-0-	60	300
Net Benefit	$2,900	$2,540	$ 700

*Or other coverage applied.

Chapoton's view of the effect of pre-tax dollars used for purchasing health care services. 23 TAX NOTES 547 (1984).

EXHIBIT II

CATASTROPHIC MEDICAL PLAN PREMIUMS

Cafeteria Plan: Premiums for 2 medical plan options or cash

Plan A: $200 deductible, 80% to $2,500 then 100% thereafter
Plan B: $500 deductible, 80% to $5,000 then 100% thereafter

Spending Account:	$1,000
Plan A Cost:	$1,000
Plan B Cost:	$ 800
Medical Bills:	$ -0-

Employee: 30% marginal tax rate; no other medical bills.

	Plan A	Plan B	Cash
Plan Reimbursement	$ -0-	$ -0-	$ -0-
Employee's Medical Expense*	-0-	-0-	-0-
Unused Spending Account	-0-	200	1,000
Gross Benefit (reimbursements plus cash)	-0-	200	1,000
Less Taxes	-0-	60	300
Net Benefit	$ -0-	$ 140	$ 700

*This is somewhat misleading since the employee receives a value for being "covered" just in case of a claim.

a lesser medical plan, and thus, keep medical care utilization low.[146] Naturally, the lower the medical bills, the better off the employee is with the selection of a lesser plan or the selection of cash only. Hence, economic efficiency is encouraged since the employer contributions are not used to purchase more medical care coverage than is needed or valued by the employee. The plan also improves employee relations by providing a program which fits employees' personal needs. Finally, the choice of a lesser plan, or of a full cash option, will free dollars for taxation that were previously used inefficiently on a pre-tax basis.[147] Thus, revenues are enhanced by the use of a spending account in conjunction with the purchase of catastrophic medical plan coverage on the part of employees.

Exhibits III and IV below respectively illustrate the effect of large and small medical expenses on the employee's net benefits in three circumstances under a "routine expense reimbursement plan." The spend-

146. *See supra* notes 132-38 and accompanying text.
147. *See supra* notes 144-45 and accompanying text.

ing account approach is illustrated in the "forfeiture" column and reflects the forfeiture requirements in the proposed regulations.[148] The "nonforfeiture" column illustrates the effect on the employee where spending accounts were designed with cash-out provisions prior to the proposed regulations. The right hand column illustrates the effect on the employee where no "routine expense reimbursements" were allowed within cafeteria plans using a spending account approach. The assumption is made in the forfeiture column that the full spending account is allocated at the beginning of the plan year to medical reimbursement.

The employee in Exhibit III is better off with "routine expense reimbursement" when unreimbursed expenses equal or exceed the amount in

EXHIBIT III

ROUTINE EXPENSE REIMBURSEMENTS/EFFECT ON NET BENEFITS

Cafeteria Plan: Routine Expense Reimbursements or Cash

Catastrophic Medical Plan: $200 deductible; 80% thereafter of next $5,000

Spending Account	$1,000
Medical Bills	4,200
Plan Pays: ($4,200 − $200) × .8 =	3,200
Unreimbursed Expenses: $4,200 − $3,200 =	1,000

Employee: 30% marginal tax rate; no other medical bills.

	Routine Expense Reimbursement: Forfeiture	Routine Expense Reimbursement: Non-Forfeiture	No Routine Expense Reimbursement
Available for Cash & for Reimbursement	$1,000	$1,000	$1,000
Expense Reimbursement	1,000	1,000	-0-
Unused Spending Acct.	-0-	-0-	1,000
Available for Cash	-0-	-0-	1,000
Gross Benefit	4,200	4,200	4,200
Less Taxes, Forfeitures, and After-tax Medical Expenses	-0-	-0-	300
Net Benefit	$4,200	$4,200	$2,900

148. Proposed Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,325 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

EXHIBIT IV

ROUTINE EXPENSE REIMBURSEMENTS/EFFECT ON NET BENEFITS

Cafeteria Plan: Routine Expense Reimbursements or Cash

Catastrophic Medical Plan: $200 deductible; 80% thereafter of next $5,000

Spending Amount	$1,000
Medical Bills	800
Plan Pays: ($800 − $200) × .8 =	480
Unreimbursed Expenses: $800 − $480 =	320

Employee: 30% marginal tax rate; no other medical bills.

	Routine Expense Reimbursement		
	Forfeiture	Non-Forfeiture	No Routine Expense Reimbursement
Available for Cash & for Reimbursement	$1,000	$1,000	$1,000
Expense Reimbursement	320	320	-0-
Unused Spending Acct.	680	680	1,000
Available for Cash	-0-	680	1,000
Gross Benefit	1,480	1,480	1,480
Less Taxes, Forfeitures, and After-Tax Medical Expenses	680	132	620
Net Benefit	$ 800	$1,118	$ 860

the "routine expense reimbursement" account. In Exhibit IV, the employee is clearly better off in the nonforfeiture situation since the unreimbursed medical expenses after application of the catastrophic plan benefit formula are less than the amount available within the spending account for "routine expense reimbursements". Unfortunately, the proposed regulation preclude this approach.[149] However, the employee is somewhat better off than in the forfeiture situation if "routine expense reimbursements" are not allowed within cafeteria plans. Although the forfeiture provision may reduce overall plan costs by returning unused dollars to the employer, it actually provides an incentive for the employee to utilize further medical services that are discretionary and perhaps unnecessary in hopes of gaining a value from the spending account

149. *See supra* notes 98-03 and accompanying text.

instead of forfeiting it.[150] Thus, the current status of "routine expense reimbursements" under section 125 and the proposed regulations does not encourage lower utilization of health care services.

If "routine expense reimbursement" is not allowed under a cafeteria plan, the employee is better off when routine medical expenses are lower than the amount which would have been available through a spending account arrangement requiring forfeiture. The employee is not as well off as with the nonforfeiture approach, but the nonforfeiture approach may still encourage utilization of routine or unnecessary expenses since the pre-tax dollars are less valuable to the employee than the after-tax dollars.[151]

Finally, the exclusion of "routine expense reimbursements" from cafeteria plans spending account arrangements consistently provides greater revenue from the employee taxable income perspective when compared to the spending account approaches. As the employee's utilization of medical care services is reduced, catastrophic medical plan expenses are reduced and revenue is enhanced from the corporate taxable income perspective as well.

The foregoing analysis indicates that when used to provide catastrophic medical expense plans, cafeteria plans and spending accounts are valid approaches to cost containment from both a national health care and tax policy stand point. However, the use of spending account arrangements in conjunction with "routine expense reimbursement" plans is questionable. The problem lies in section 105, and not in section 125. A revision of section 105 to mandate the qualification of only catastrophic medical plans for tax-favored treatment generally and inclusion in section 125 is a viable solution. At the very least, consideration should be given to excluding "routine expense reimbursement" plans from cafeteria plans.

This conclusion is consistent with the goals of revenue enhancement and economic efficiency. Equitable provision of benefits is enhanced since the highly compensated employees are usually better able than the lower paid employees to utilize the "routine expense reimbursement" feature. The mandate of catastrophic plans also provides income security to the private sector in the event of significant medical expenses for the em-

150. *See supra* notes 132-34 and accompanying text.
151. *See supra* note 143 and accompanying text.

ployee. This approach is consistent with the rationale behind increasing the threshold for itemized medical deductions.[152] It is also preferable to the proposed cap on employer health care contributions[153] which could encourage first-dollar coverages with low coverage maximums. This plan design could leave significant medical expenses to fall on the public welfare system.

VI. CONCLUSION

Cafeteria plans and spending accounts are viable tools for the containment of health care costs. However, the tax-favored status of "routine expense reimbursement" plans conflicts with the national goal of health care cost containment and should be ended with a revision of section 105.[154] This revision should mandate "qualified catastrophic coverage" plans which leave routine medical expenses to the employee for payment with after-tax dollars.

Eliminating the tax-favored treatment of "routine expense reimbursement" plans solves the availability-of-cash problem which individual salary reduction agreements create within cafeteria plans. These plans also have the potential for discrimination in favor of highly paid employees. The imposition on welfare plans of rules designed for deferred compensation plans is unworkable.[155] Therefore, the use of individual salary reduction agreements, apparently allowed by the proposed cafeteria plan regulations, should be abandoned.

Finally, more flexibility in timing of benefit selections and receipt of cash should be allowed. A participant should be able to elect out of a catastrophic medical plan during the middle of the plan year, irrespective of any change in family status, and collect the unused spending account balance in cash. Section 125 was designed to allow this flexibility of benefit plan design and at the same time protect participants from taxable income due to the constructive receipt doctrine.[156] The proposed regulations negate the intended effect of section 125.[157] A revision of the proposed regulations toward more flexibility in the absence of "routine

152. I.R.C. § 213 (1984).
153. S. 640, 98th Cong., 2d Sess. (1984).
154. *See supra* notes 141-53 and accompanying text.
155. *See supra* notes 127-28 and accompanying text.
156. *See supra* note 122 and accompanying text.
157. *See supra* notes 21-57 and accompanying text.

expense reimbursements" and individual salary reduction agreements would assure fair and meaningful provisions in cafeteria plans.

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